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How Much Is Your Invention Worth or How Much Should You Pay to License Inventions?

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Licensing Agreements Are the Cornerstones of Technology Companies Based on Intellectual Property.

Licensing agreements are the cornerstones of technology companies based on intellectual property. A licensing agreement is a legal contract between two parties, known as the licensor and the licensee. The licensor provides the licensee a right to use and a limited license, while the licensee accepts a series of conditions related to use of the product and payment for such use.

How Is the License Valued?

The value of the license is the sum for which the “licensor at will” sells the license to the “licensee at will.” However, how do the parties know how much to ask for or how much to pay for the license? How do companies know if investment in a certain license is worthwhile? These questions are particularly pertinent for licenses that will only bear fruit a few years later.

Because of the difficulty in assessing the value of a license at the time of executing a contract, its value is generally set as a percentage of the sale of products that rely on the invention for which the license is granted. These percentages are called a “royalty,” and they constitute a model for distributing profits between the inventors and technology companies that use the invention to manufacture and market products.

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How Is the Royalty Rate Set?

Because of the difficulty in calculating the royalty rate, several rules of thumb were established to determine the royalty rate, according to industry and product, as well as according to a comparison of the customary royalty rate for similar products and similar transactions, called “benchmarking.” Understanding the source of these rules of thumbs will be very helpful in cases where setting the royalty rate is a challenge.

The first rule for setting the royalty rate for a license to use intellectual property is the “25 percent rule.” This rule provides that the royalty rate a user of another’s intellectual property must pay to the owner of that intellectual property is 25% of the operating profit of that product.

The 25 percent rule assumes the licensor and the licensee must share the profit deriving from use of the license and that the licensee accepts most of the profit (75%) as the party assuming most of the expenses and, in turn, most of the risk.

Therefore, under the 25 percent rule, in industries where the average operating profit is about 12% (such as the chemicals industry), the average royalty rate is about 3%. In an industry where the average operating profit is about 18.5% (such as the medical products industry), the average royalty rate is about 4.5%. Finally, where the average operating profit in a certain industry is about 26% (such as the pharmaceutical industry), the average royalty rate is about 6.5%.

A study presented in Robert Goldscheider’s famous article (some name the 25 percent rule for him, i.e., the “Goldscheider Rule”), which researched 15 of the world’s leading industries as well as successful licensing agreements between the years 1980-2000, found that the external royalty rate was 4.3%, which constitutes about 26.7% of the average operating profit.

A later study by the accounting firm KPMG’s Global Valuation Institute, in 2012, tested the validity of the 25 percent rule and the scope of its use, according to the customary royalty rate in 14 leading industries. The study found that

even in the years after the Goldscheider article, the royalty rate for granting a license continued to meet the 25 percent rule.

However, the KPMG study also found that the 25 percent profit rate comes from a company's EBITDA (earnings before interest, tax, depreciation and amortization). Using EBITDA instead of operating profits results in a more accurate distribution of the company's profit as it derives from the license's contribution. This is because it takes out of the equation mathematical and financial considerations not necessarily related to the license's contribution to the profit made by the product based upon the license.

In conclusion, understanding the source for determining the royalty rate is an important first step in calculating it. Evaluating the actual royalty rate depends not only on the customary profit or EBITDA in the relevant industry, but also on additional factors such as the size of the market the product targets, the date of the product's entry into the market, and the investment necessary until the product hits the market.

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